LIABILITY OF DIRECTORS OF NONPROFITS IN CALIFORNIA

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In 1986, legislation was proposed by the Business Law Section of the State Bar which would amend the California General Corporation Law in a fashion similar to that seen in Delaware and New York with respect to the limitation of liability of directors for monetary damages, etc. At that time, the Nonprofit Corporations and Unincorporated Associations Committee (the "Committee" herein) determined that comparable legislation should also be proposed for public benefit, mutual benefit, religious and cooperative corporations. As with business corporations, nonprofit corporations have been periodically faced with an inability to obtain directors and officers liability insurance; in addition, they have had to face the uncertain effects of the California Supreme Court decision in the Village Green case (see below). The combination has made it extremely difficult for many nonprofits to find qualified directors: "People are simply unwilling to jeopardize their family assets through volunteer work." Tax Exempt News, February 4, 1987, attached.

As a result of these concerns, appropriate language was added to AB1530, to provide the same type of limitation of liability for directors of nonprofits as was proposed for business corporations. As Willie Brown correctly stated in an April 17, 1987 letter:

"Other states, principally Delaware and New York, have recently acted to authorize corporations to limit the liability of directors for monetary damages, or expanded the scope of indemnification available to officers and directors. Other major commercial states are following suit, authorizing the limitation or restriction of the liability of directors, and expanding the scope of permitted indemnity for officers and directors. **Consequently, many have reincorporated or are considering reincorporation in Delaware and other states**." (emphasis added)

These other states, have generally extended this limited liability to nonprofits. However, for some reason unknown to the Committee, the California provisions providing protection for nonprofit directors were stricken from the bill at the last minute and AB 1530, as adopted, applied only to business corporations.

After the language applicable to nonprofits was eliminated from AB 1530 in 1986, the Committee attempted, for a number of years, to obtain a rehearing on this matter from the legislature. However, due to concerns of the State Bar, a new proposal was not introduced, with the support of the Bar, until 1989.

On May 22, 1990 the governor approved AB No. 2292, which was sponsored by the Nonprofit and Unincorporated Organizations Committee. This bill was designed to address several problems contained in the present law concerning the liability of directors of nonprofit corporations. Although the bill achieved some success in this area, it was clearly simply a technical corrections bill, and was not designed to make substantive changes in the law. Therefore, the law concerning liability of directors of nonprofit corporations continues to be confusing, inconsistent, contradictory and unclear both with respect to the organizations entitled to protection, and to the extent of the protection actually provided.

The second bill that was sponsored by our committee, AB 1125, was introduced at the same time. It was, with minor modifications, a restatement of the language that had been eliminated from AB 1530. The Committee for the reasons set forth above, as well as for the following reasons, requested that AB 1125 be adopted:

Additional Reasons for Adopting AB 1125.

1. Since the adoption of the Nonprofit Corporation Law (NCL) which became effective January 1, 1980, it has been our state's legislative policy to treat directors of NCL corporations in the same manner as those of their General Corporate Law (GCL) counterparts -- i.e. to give NCL directors the same protection as made available to GCL directors. The legislative history (See Comments Based on Legislative Committee Summary to California Corporations Code Section 5231) and the statements published by participants in the drafting of the NCL, state that this was deemed to be a desirable and fair result (See Ballentine and Sterling, California Corporations Law, Section 401.04 at 19- 47 and 48). However, the amendment of the GCL sections and not the comparable NCL sections **has permitted the directors of GCL corporations to be treated in a more favorable light than directors of nonprofit corporations**. In view of the Committee, such a disparity, if allowed to continue, would be a mistake and an undesirable policy. Directors of NCL corporations generally serve without compensation and are pursuing public or eleemosynary purposes. GCL directors, on the other hand, are generally compensated and pursuing solely pecuniary motives.

2. The boards of directors of California nonprofit corporations are largely served by volunteer or nonpaid directors. Because of the difficulty in obtaining directors' and officers' liability insurance, and such directors fear of liability (particularly in light of the recent California Supreme Court decision in Francis T. v. Village Green Owners Association 42 Cal 3d 490), charitable corporations are having a difficult time keeping or attracting directors to serve on their boards. It is the view of some members of our Committee, that directors' and officers' insurance premiums are based, in part, upon the experience ratings of GCL corporations. Because of the large judgments against GCL corporations, directors' and officers' insurance for nonprofits has become either unavailable or extremely expensive. To permit directors of GCL corporations to be afforded statutory protection without providing the same protection to their nonprofit counterparts will, in our view, simply exacerbate this situation.

3. In large part, AB 1530, as adopted, follows the Delaware legislation adopted in June of 1986 (although the Delaware law also applys to nonprofits -- see Delaware Corporation Law Section 104). Thus, to the extent that the justifications for the GCL legislation (e.g., concern with corporations leaving the domicile of California and reincorporating in Delaware or another state with similar legislation) apply, these same justifications apply to nonprofit corporations. This "corporate flight" might even be a more attractive option to nonprofit organizations because the NCL has no complement to the quasiforeign corporation sections found in California Corporations Code Section 215.

4. Because this question of liability continues to be a major concern

of a number of nonprofits, it is expected that special interest groups will continue to advance legislation designed to protect their specific group unless there is a coherent statutory format adopted that will provide such protection to each group. See, e.g. AB 962, introduced in 1989, to limit the liability of directors of credit unions. By adopting AB 1125, the legislature will likely limit the number of bills on this matter that it will have to consider, and will be able to provide for consistency of treatment between the various nonprofits.

It should be noted further, that AB 1125, as it is presently constituted, applys to all nonprofit corporations (public benefit, mutual benefit and religious), as well as to consumer cooperatives.

Previous Objections of Attorney General.

At the time AB 1530 was proposed in 1987, we understand that the Attorney General had advanced some opposition to the bill. It is also our understanding that an agreement had been worked out with them and that they had agreed to withdraw their opposition. However, because they might determine to renew their opposition, the following is an attempt to summarize our view of what their opposition had been, and to provide you with our explanation of why this legislation is desirable, notwithstanding such objections.

As we understand it, said opposition had been based on the concern that such amendments would hamper the Attorney General's enforcement prerogatives, and would encourage incompetence and would make it harder for the Attorney General to prove bad faith.

These arguments are premised somewhat on the theory that the threat of monetary liability will encourage good behavior in the charitable community; we feel this premise would be difficult if not impossible to prove. It is our view that "bad actors" will take their nefarious actions notwithstanding the consequences. We also feel that our Committee's proposed legislation has "carved out" important exceptions to the limitation of liability, including liability (i) for omissions or acts committed in bad faith or which involve intentional misconduct or a knowing violation of law, (ii) for any omission or act believed to be contrary or inconsistent with the best interest of the corporation; (iii) for transactions in which the director derived an improper personal economic benefit, and (iv) for self-dealing, unlawful distributions, loans and guarantees. As you can see, breaches of the duty of loyalty to the corporation were not intended to be included, nor were intentional misconduct, a knowing violation of the law or transactions from which the director received an improper benefit. Therefore, we feel that the Attorney General still has the tools with which to enforce an extremely broad range of violations of the California Corporations Code which are not subject to the limitations of our proposed legislation.

Moreover, it should be noted that our proposed legislation only provides directors with relief from monetary damages for breaches of duty of care; it does not eliminate the duty. Accordingly, our proposal does not affect equitable remedies such as injunction or recission based on a director's breach of the duty of care.

It is the view of our Committee, that these objections are no different than objections to the GCL revisions contained in AB 1530 that might have been raised by the plaintiffs' bar interested in securing large judgments from proprietary corporations and/or their directors. We feel, because of the volunteer nature of boards of charitable organizations that directors of nonprofit corporations should be treated at least as well as (if not better than) their proprietary counterparts.

In summary, this bill which had been introduced in the 1989 legislative session by the Nonprofit and Unincorporated Organizations Committee, AB 1125, would have extended the same protections given to directors of business corporations, to directors of nonprofits. This bill died in committee, in part because counsel for the legislative committees did not want to consider it at that time.

We then changed our approach to the drafting. The subsequent bills the committee drafted differed substantially from the approach previously used, of making the law consistent as between business corporations and nonprofits. This new approach recognized that, while directors of business corporations are primarily faced with lawsuits from disgruntled shareholders, directors of nonprofits generally are sued by third parties for such matters as wrongful termination, and that the real need with regard to nonprofits is to limit third party suits when the action is more properly brought against the corporation.

However, this protection would be extended only to directors of public benefit and religious corporations, and not to mutual benefit corporations or cooperative corporations. The proposed bill's provisions for mutual benefit and cooperative corporations are drafted to conform the laws which regulate these corporations, to the same type of director protections as are presently available to directors of business corporations. The Committee did not consider it appropriate to extend the public benefit/religious director liability provision to mutual benefit corporations and cooperatives, because such corporations are more analogous to business corporations, and are not subject to the same public policy considerations concerning attracting persons to serve as directors of charitable and religious corporations.

This bill was introduced in 1992, as AB 3762. The summary of this bill read as follows:

> The status of liability of directors and officers of business corporations in California was clarified with the 1987 adoption of AB 1530. This bill, adopted in response to a change in the Delaware law, allowed business corporations to limit the liability of their officers and directors, and also to provide additional indemnification for agents, including officers and directors.
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> This same protection was not extended to nonprofit corporations. Rather, several laws have been passed since that time that purport to provide some limited liability to nonprofit directors and officers. Unfortunately, these laws, although well-intentioned, have had various internal inconsistencies that give the nonprofit director the impression of having some limited liability, without the same actually occurring.
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> AB 3762 is designed to correct these various problems through three steps:

1. Protection given to directors and officers of business corporations is also given to nonprofit corporations, including mutual benefit corporations and cooperatives. Because mutual benefits and cooperatives have been considered to be distinguishable from nonprofits, they have been in the unenvious position of receiving neither the protection that was given to business corporations, nor the limited protection afforded other nonprofits. This bill will correct this mistake. (See Secs. 2, 3, 4, 6 applicable to public benefit corporations, Secs. 8, 9, 10, 11 applicable to mutual benefit corporations, Secs. 12, 13, 14, 16 applicable to religious corporations, and Secs. 18, 19, 20, 21 applicable to cooperatives.)

2. While most suits against directors of business corporations have been by shareholders of the corporation, nonprofit public benefit and religious organizations do not have shareholders. Most suits, therefore, against directors of nonprofit public benefit and religious organizations are from third parties. At the same time, many, if not most of these organizations have very few assets, in the event a third party does sue the organization. This bill attempts to rectify both of these situations by limiting the individuals who can sue the directors and officers of nonprofit public benefit and religious organizations when they are acting in their respective capacities, but provides such limitation only when a) there is an action that can be taken against the organization and b) there are assets (generally insurance) that will provide coverage for the claim. (See Sec. 5 applicable to public benefit corporations, Sec. 15 applicable to religious corporations, and Sec. 22, applicable unincorporated associations which, if incorporated, would be nonprofit public benefit or religious corporations.)

3. Inconsistent provisions presently contained in the Nonprofit Corporations Code are repealed. (See Secs. 7, 17.)

Subsequent bills were introduced in 1993, 1994 and 1997.

At that point, we gave up.

It should be noted that during this time, several other bills addressing the issue of liability of directors of nonprofits were ultimately adopted by the California legislature. However, none of these gave nonprofit directors the same protection as is afforded directors of business corporations. Further, there remain problems with the law, such as lack of clarity concerning who is to be covered, and a requirement that insurance (which may be unavailable) be purchased before liability will be limited. See “The Night the Sky Fell,” http://www.runquist.com/article_night.htm

Cooperative corporations and mutual benefit corporations have come out on the bottom as a result of these changes. Because they are not covered by the business corporation law, the protection granted to directors of business corporations was not extended to them. However, because they may have business purposes and may benefit their members, and are thus not "charitable" in their entirety, they have generally not been considered "worthy" of what little protection has been given to directors of nonprofit corporations either.